Introduction to *Accounting and Business Research* Special Issue

Financial analysts' role in valuation and stewardship

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Financial analysts intermediate in capital markets by bridging significant gaps in the information held by firms and investors. Through their valuation and monitoring activities, financial analysts are viewed by many as crucial in ensuring the efficient allocation of capital, increasing market liquidity and improving investor confidence. Yet despite their significance in the corporate information environment, analysts are also regularly criticised for lacking objectivity. Since the high profile corporate scandals of the early 2000s and the financial crisis of 2007-08, important concerns have been raised about financial analysts' capabilities and effectiveness. Threats to analysts' impartiality introduced by a need to maintain relationships with management and to help maximise brokerage and investment banking income are often accepted as inescapable features of the information environment.

In light of these points, it is unsurprising that the literature on the financial analysts and their outputs is so vast. Researchers have exploited the availability of large databases to address various questions, such as how analysts perform relative to mechanical models in earnings forecasting, how influential analysts' outputs are in security price formation and how successful analysts are in processing accounting information of various kinds. Nevertheless, there are important issues left untouched by academic research. The prior literature also stands accused of having a comparatively narrow topical and methodological focus (e.g. Bradshaw, 2011). Moreover, the regulatory and institutional environment of analysts is a highly dynamic one. We are therefore pleased to introduce this special issue of *Accounting Business Research*, with the wide variety of subjects it covers and the range of theoretical and methodological approaches taken to address them.

Aiming to assess the validity of concerns about the rigour and objectivity of analysts' research, Salzedo, Young and El-Haj (2018) apply manual content analysis and natural language processing methods to study the activities of U.S. sell-side analysts. They form predictions, based on the cognitive processing literature, that analysts are more likely to undertake rigorous research when the firms they follow receive unexpected news. This is particularly the case for unexpectedly poor earnings news. They provide empirical evidence

from conference call questions and research notes consistent with their predictions, and demonstrate that analysts often confront and challenge management, particularly when earnings performance is lower than expected. These findings differ from a prominent school of thought that analysts' research tends not to be neutral and is institutionalized by material conflicts of interest, as well as excessive reliance on firms' management (Fogarty and Rogers, 2005; Kothari et al., 2009; Huang et al., 2014). The research of Salzedo et al. (2018) has important implications for our understanding of analysts' role in equity valuation because it indicates that analysts can be proactive, rather than passive in their research, and can therefore enhance the information available to investors (arguably when this role is needed most). The findings challenge some of the arguments about the lack of rigour of analyst research and the lack of analyst independence. The novel empirical examination of conference calls also exemplifies analysts' active role in holding management accountable on investors' behalf via verbal, rather than written, means.

Ho, Strong and Walker (2018) examine whether and how analysts' target price forecasts for U.K. firms respond to key information sources, including market returns, excess stock returns, and other analysts' target price revisions. They document that, after controlling for analysts' own concurrent earnings forecast and recommendation revisions, target price revisions are significantly associated with these factors, especially when bad news is conveyed. Their study answers calls for more research on analysts' outputs beyond earnings forecasts (Bradshaw, 2011) and differs from other existing papers on target prices that tend to focus on the consequences, rather than determinants, of such forecasts (e.g. Brav and Lehavy, 2003; Asquith et al., 2005). We infer from Ho et al. (2018) that when valuing equities, analysts incorporate and disseminate both market-wide and firm-specific information. Their findings also indicate that by being sensitive to firms' strategic disclosure behaviour and tendencies to withhold negative information (Kothari et al., 2009), analysts contribute to investors' monitoring against managerial opportunism.

In a theoretical analysis, Schantl (2018) develops a model showing that analysts' research can be either substitutive or complementary to corporate disclosure. Which role dominates depends on managerial incentives associated with their (uncertain) price interest and propensity to meet or beat analysts' earnings forecasts. The model suggests that the substitutive function of analysts' research tends to dominate when the information cost is sufficiently low for analysts. An interesting feature of this model is that the analyst's and

manager's incentives interact with each other in such a way that the analyst's forecast remains a potentially relevant information source, even after earnings are reported. The paper thus contributes to a large literature on financial analysts that tends to take a mainly empirical perspective, and which has so far generated conflicting evidence on whether analysts substitute or complements firms' disclosures (Asquith et al., 2005; Chen et al., 2010). In examining the valuation role of analysts, Schantl (2018) suggests that the informativeness of analysts' research outputs can be sensitive to their information acquisition costs. The model also identifies managerial incentives and opportunism as important determinants of analysts' role as financial information intermediaries, thus questioning analysts' stewardship capabilities.

Chen, Wright, and Wu (2018) study the extractive industries in Australia to examine whether analysts' private information and forecast performance are influenced by firms' exploration and evaluation activities. Such activities are argued to be associated with a higher level of information asymmetry and may therefore lead to greater investor reliance on analysts' expertise. The paper shows that the proportion of analysts' private information increases with the intensity of exploration and evaluation, and that this effect is more pronounced among firms with limited production activities. Such evidence contributes to the literature on how analysts' forecasts can be affected by intangible assets (Barth et al., 2001; Frankel et al., 2006). This issue is increasingly important due to the rapid changes in technology and firms' competitive environment. This study offers empirical support for the idea that analysts' industry-specific experience and expertise represents an incremental contribution to investors' information environment. The results also imply that analysts may improve the protection of investors in a high information asymmetry environment, where the risk of insider expropriation is potentially high.

Yin, Peasnell and Hunt III (2018) seek to determine how analysts arrive at the price-earnings multiples they apply in their valuations. Based on U.S. data, they show that analysts are more likely to assign such multiples at a premium (discount) to firms that are anticipated to be associated with higher growth (risk). They interpret this as evidence that analysts' valuation processes are broadly consistent with the Ohlson and Juettner-Nauroth (2005) abnormal earnings growth model. This study offers important insights into the implementation of a relative valuation approach, which existing research confirms is widely adopted by financial analysts (e.g. Demirakos et al., 2004; Cascino et al., 2014) and yet its underlying

determinants remain largely under-explored. Yin et al. (2018) thus provide reassuring evidence that relative valuation through price-earnings multiples is driven by economically important fundamental factors. Their study also implies that corporate disclosure of firm performance results in externalities for peer firms through analysts' usage of a relative valuation approach that captures fundamental information associated with risk and growth.

Even if analysts' institutional environment were stable over time and across jurisdictions, we would still have much to learn about analysts' roles in valuation and stewardship. But regulatory, economic, political and technological forces are dramatically shaping the world of the financial analyst and other capital market participants. The large and long-standing literature on financial analysts therefore still leaves a wealth of opportunities for future research. For instance, what factors enhance or inhibit financial analysts' 'early warning' function over major capital market upheavals? What will be the effects of price-driven demand shocks on analysts' roles? Will new regulatory interventions help ensure analysts mitigate the chances of another string of accounting scandals or the excessive risk taking that characterised the 2007-08 financial crisis? The new European Markets and Financial Instruments Directive has been designed to restructure and improve sell-side analyst research in fundamental ways, particularly by 'unbundling' it from other brokerage activities. Will this result in greater impartiality and higher research quality, as the regulators plan? Important policy reforms in emerging economies also represent worthy research settings to gain further insight into the determinants and consequences of analyst research.

As the papers in this special issue illustrate, the predominant focus of existing academic literature is on sell-side equity analysts. As a result, there are potentially significant gaps in our knowledge of other types of analysts, such as buy-side equity analysts and credit analysts. It is far from clear that the findings from the sell-side carry over to other analyst types. Differences in security payoff structures, incentives, resources and responsibilities seem highly likely to influence the roles of these other important analysts. The regulatory interventions above may also alter these differences in significant ways. Finally, the information environment itself is evolving at pace. Increasing demand for non-financial information, together with the pervasiveness of technology in financial markets, have the potential to transform analysts' roles even further, including changing the criteria by which they are judged.

In summary, there is significant evidence presented in the papers in this special issue that analysts perform important functions in both valuation and in enhancing stewardship, even though potential biases sometimes need to be adjusted for. Taken together, the papers show that the objectives, capabilities and roles of analysts are more complex than is sometimes assumed. Despite potential conflicts of interest, the consequences and implications of analysts' incentives are not always easy to anticipate. The papers also identify and test the circumstances under which analysts' role and performance varies, such as when firm performance is low, where firms withhold information and when information acquisition costs are low. We hope and expect that the papers in this issue will generate further debate and research into these important intermediaries and the roles they play in capital allocation.

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